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SUBJECT: INFLATION TROUBLE IN TURKEY

Ref: Ankara 1026

¶1. Summary: Following May CPI inflation data that signaled the return of double-digit inflation for the first time since 2004, the Central Bank of Turkey (CBRT) significantly revised upward its official inflation target for 2009, 2010, and 2011 to 7.5%, 6.5%, and 5.5%, respectively. Inflation management has been on track since 2002, but was hit hard by high energy and food prices and loose GOT fiscal policy. The May announcement took annual rates (May 2007-May 2008) of CPI and PPI inflation to 10.7% and 16.5%, respectively. In an exchange of public letters, both the CBRT Governor Durmus Yilmaz and Treasury Minister Mehmet Simsek suggested the target revisions were timely and were made in compliance with current market conditions and the Medium-Term Economic Program that will be made public later in June. Immediate markets reaction to the May inflation data and new targets was negative. End Summary.

Inflation Data

¶2. On June 3, the Turkish Statistics Agency (TUIK) announced May inflation data, moving Turkey back to double digits. In May, CPI increased 1.5% month on month, above the consensus estimate of 1.1%, while the PPI increased 2.1% month on month. These monthly rates took the annual rates of CPI and PPI inflation to 10.7% and 16.5%, respectively. Year to date (January-May 2008) inflation became 6.38% for CPI and 13.39% for PPI. In May, clothing prices increased by a whopping 12%.

Background on Inflation Targeting

¶3. To put these numbers in perspective, it is interesting to note that inflation in Turkey was 84.6% in 1998, 25.3% in 2004, and has been under 10% since 2005. The CBRT adopted the inflation targeting regime under the 19th IMF stand-by arrangement in 2005. Despite setting inflation targets of 4% for 2006 and 2007, Turkey was only able to reach year-end levels of 9.6% and 8.4%, respectively. Since 2007, the CBRT has been struggling with GOT overspending on elections. Since the end of 2007, global increases in oil and food prices have hit Turkey hard, and the previous targets were no longer sustainable.

New Inflation Targets

¶4. After the TUIK announcement, the CBRT revised its inflation targets for 2009, 2010, and 2011 to 7.5%, 6.5%, and 5.5%, respectively, up from 4% across the board, noting that current inflation targets no longer served as a short-term nominal anchor. The CBRT said persistent supply shocks and global economic uncertainties have increased risks on the inflation outlook, and it will take until at least 2012 to reach 4%. The CBRT had already signalled a possible amendment in its inflation target and these

revisions were expected. They justified making the announcement now to meet the GOT's need for accurate inflation guidelines for its Medium-Term Economic Program, which is expected to be announced in June, and which will be used to formulate the 2009 budget.

¶5. Under Article 4 of the Central Bank Law, inflation targets are determined jointly by the Central Bank and the Government. This is done transparently by an exchange of public letters. In its June 4 letter, the CBRT said "our assessments suggest that, even under the maintenance of a cautious policy stance, reaching the four percent target is likely to take an extended period. Food and energy prices continue to pose risks to the medium term inflation outlook, and there is no clear evidence that this trend will reverse in the short term". Treasury Minister Simsek wrote back to the CBRT that the GOT considered the proposed targets "appropriate" and vowed to support the independent institution in its fight against inflation. Despite on-going tensions between the GOT and the CBRT over looser fiscal policy, Simsek agrees the CBRT is doing the right thing on inflation now.

Reactions

¶6. Higher inflation and the revision announcement caused Turkish markets to react negatively on June 4. The Turkish lira (TRY) depreciated 1.6% against the USD to 1.24, and government bond rates increased to their highest level since March 16, reaching 20.28%. Equities lost about 1%. Although it was expected, economists and analysts regarded the Central Bank's change in the inflation target as a credibility loss and claimed that monetary policy management is now weaker than in earlier years. Ferhat Emil, former CBRT vice governor and now an Ankara University professor, said he did not

expect monetary tightening to succeed sufficiently to down inflation without the application of tight fiscal discipline, especially in a world of rising food and energy prices. Central Bank Markets Department Manager Cigdem Kose told us there is not much room for a CBRT price stability program under current global conditions as long as there is increased government spending. The CBRT must have support and tight fiscal policies from the GOT to succeed with its inflation management goals.

¶7. EFG Economist Baturalp Candemir pointed out that double-digit inflation will also lead to an inflation compensation payment to civil servants. He expects an across-the-board 1.4%-4.8% civil servant wage increase. By his calculations, each percentage point of inflation compensation will cost the GOT a budget-busting TRY 250 million (USD 201.6 million). (Note: News sources report that Simsek said the GOT will provide inflation compensation for civil servants. End note.)

Expected Outcomes

¶8. On the market side, Murat Gulkan from Deutsche Securities said he saw carry investors focusing more on short-term bonds. Rising inflation, a Central Bank frustrated by loose GOT fiscal policy, and political uncertainty will make it challenging to roll over GOT debt totaling TRY 25 billion (USD 20.2 billion) in July. As a result, he expects to see a further rise in government bond rates to a range of 21-23%. Gulkan also points out that rising rates are bad news for equities and current circumstances will make investors reluctant to buy long-term government bonds.

¶9. Comment: Revising inflation targets, although needed, have caused a credibility loss for the CBRT and the GOT. With the inflation targets of the past two years missed and the 2008 target clearly out of reach, economists have been arguing that the 4% target was no longer perceived as an anchor by the markets, business circles, or even the GOT. Market players expect further rate hikes when the Central Bank's Monetary Policy Committee meets on June 16. The GOT's loose fiscal policy might promote growth, but it plays havoc with inflation management. End Comment.